

Explanation of Revised Discussion Draft for Proposed Regulation Section 25136

The discussion draft has been revised. The revised draft attempts to take into account the comments and concerns of various interested parties raised during and subsequent to the Interested Parties Meeting held in July 2010 ([see Summary](#)). However, decisions had to be made that resulted in not all the parties' recommendations being adopted. The key revisions are set forth with explanations below.

1. General Definition Section. The first part of the draft addresses the general definitions of the various terms contained in the rules to follow.

The definitions for the terms "purchaser" and "benefit of a service" have been combined under a definition for the term "Benefit of a service is received." This term is defined as the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service. Examples have been provided.

A definition for the term "Service" has been added: "a commodity of activities engaged in by a person for another person for consideration." It does not include activities performed by someone who is not a regular trade or business offering services to the public nor does it include services rendered to a member of an affiliated group by another member of that same affiliated group that does not sell those same type services to the public.

The definition of the term "to the extent" has been eliminated as being redundant as that term is explained in each provision for assignment of services and intangibles.

The term "cannot be determined" has been generally defined under the General Definitions section. However, the provision regarding the Franchise Tax Board accepting a reasonable approximation where, for instance, the necessary data of a smaller corporation cannot be reasonably developed from the financial records maintained in the regular course of business, has been moved to Special Rules under (g)(1).

The term "reasonably approximated" has been modified to exclude a taxpayer's business records kept in the normal course of business along with the terms of the contract between the taxpayer and the taxpayer's customer in determining where the benefit is received or the location of the use of the intangible. Language has also been added to this definition that information that is specific in nature is preferred over information that is general in nature.

2. Benefit of the Service Section. This provision is still divided into two sections: one that applies to individuals and one that applies to corporations or other business entities.

In the provision applicable for sales to individuals, the order of the first two cascading rules has been switched. Under the revised draft, the first cascading rule provides that the individual's billing address is presumed to be the location where the benefit of a service is received. The second cascading rule now provides that if the billing address presumption is overcome, then the terms of the contract between the taxpayer and the taxpayer's customer or the taxpayer's business records are to be used to determine the location where the benefit is received. The alternate provision, the "taxpayer's books and records kept in the

normal course of business," has been added throughout the regulation wherever the term "contract between the taxpayer and taxpayer's customer" appears. (In other words, there is an equal alternative to the cascading rules that provide for determination of assignment of the sale by looking at the contract between the taxpayer and the taxpayer's customer, and that alternative is the taxpayer's business records.) If none of the above indicates the location where the benefit of the service is received, then the location of where the benefit is received is reasonably approximated. One example has been expanded to show how all the cascading rules work.

In the section that applies to corporations and other business entities, the first cascading rule is that the contract between the taxpayer and the taxpayer's customer or the taxpayer's business records (this alternative is new as discussed above) is presumed to indicate the location where the benefit of the service is received. If neither the contract terms nor the taxpayer's business records can determine the location of where the benefit of the service is received, then the second cascading rule is that the location where the benefit was received is reasonably approximated. As we did in the individuals section, we added that the reasonable approximation is to be done by reference to the activities of the taxpayer's customer to the extent the information is available to the taxpayer. If the location cannot be reasonably approximated, then the third cascade falls to the location from where the taxpayer's customer placed the order for the service, and then, if that cannot be determined, the fourth cascade drops to the taxpayer's customer's billing address. Several examples have either been modified or were added to better reflect business realities of the industry involved in the example and/or to clarify the workings of the cascading rules. One example has been expanded to show how the cascading rules work in their entirety.

3. Use of Intangible Property Section. There are two types of sales for intangible property: sales that completely transfer all rights to the intangible property from the seller to the buyer and those sales that arise from the use, licensing, lease, or rental of intangible property and do not divest the seller of its ownership rights.

Regarding sales that completely transfer all right to the intangible property from the seller to the buyer, the first cascading rule has been modified to state that the sale of the intangible property shall be assigned to the location of the use of the intangible property by the taxpayer (as opposed to the purchaser which language was in the first draft) prior to the time of purchase of the intangible property. This first cascading rule provides a presumption that the contract between the taxpayer and the purchaser of the intangible property or the taxpayer's business records (this alternative is new as discussed above) determines the location of the use of the intangible property at the time of the purchase. Again, as in the first draft, the second cascading rule is that the location of the use of the intangible property may be reasonably approximated with the added language "by reference to the activities of the purchaser as limited by the jurisdiction or jurisdictions to which the transfer applies" and then as a fall-back position, the third cascading rule provides that the sales are assigned to the customer's billing address.

For sales that arise from the use, licensing, lease or rental of intangible property, the rules have been completely changed. The approach in the revised draft is that there are two types of these kinds of licenses: marketing intangibles, non-marketing and manufacturing

intangibles, and mixed intangibles. These provisions are based on Massachusetts' laws on intangibles.

For marketing intangibles the value of the intangible is what is being marketed. For instance, the real value of a towel with a cartoon character is the cartoon character, not the towel. Therefore, these type license fees will be assigned according to ultimate customer sales in this state of the marketed product. Under the first cascading rule, the contract between the taxpayer and licensee or the taxpayer's business records is presumed to determine this state's customers for those goods. If the presumption is overcome, then the next cascading rule provides determination of this state's customers is to be reasonably approximated and this may be done by using population data of the geographic region of where the licensee markets its goods. Where the license of a marketing intangible is at wholesale rather than at retail, then the sales are assigned strictly according to population data.

For non-marketing and manufacturing intangibles, the sales are assigned according to the use in this state as determined by the first cascading rule that the contract between the taxpayer and licensee or the taxpayer's business records are presumed to indicate the location of the use of the intangible. If that presumption is overcome, then under the second cascading rule, the location of the use is to be reasonably approximated, and, as a fall-back position, under the third cascading rule, the sale is assigned to the licensee's billing address.

Where the intangible is mixed (marketing and non-marketing/manufacturing) and the fees are separately stated in the licensing contract, then the FTB will accept the separately stated amounts for assignment of the sale under this provision. If the separate statement is not reasonable, then the FTB may assign the sales under a reasonable method. Where the fees are not separately stated, then it is presumed that the fees are paid for a marketing intangible except to the extent the taxpayer or the FTB can reasonably establish otherwise.

There are examples for all three scenarios above.

The former provisions and example in CCR section 25136 regarding sales from the sale, lease, rental, or licensing of real property and sales from the rental, lease, or licensing of tangible personal property have been added.

4. Special Rules Section.

The special rule for license fees received from members of the taxpayers unitary group was deleted as being unnecessary under the new provisions above.

A special rule has been added that provides in determining a customer's or licensee's use of intangible property under (d)(2)(A) 2. for marketing intangibles, factors include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state or other data including population that reflects the relative usage of the intangible property in this state.

A special rule has been added that where a taxpayer's method of reasonably approximating the location of the benefit of the services or the use of the intangible property shall be used consistently by the taxpayer for subsequent years. A change may not be made without the permission of the FTB under conditions prescribed by the FTB.

A special rule has been provided for CCR section 25137 through 25137-14. Those provisions were incorporated by reference with changes. For tax years beginning January 1, 2011, all references to RTC section and CCR section are to the new statute and regulation operative January 1, 2011. Those sections that generally reference RTC section and/or CCR section 25136 are 25137, 25137-1 [Partnerships], 25137-2 [Contractors], 25137-4.2 [Banks and Financials], 25137-8 [Motion Picture], 25137-10 [Generals and Financials], 25137-11 [Trucking], 25137-12 [Print Media], 25137-14 [Mutual Funds].

In addition the following sections with specific language regarding income-producing activity, costs of performance or throwback provisions have been modified: CCR 25137(c)(1)(C) [Special Rules. Sales Factor], CCR section 25137-3's [Franchisors], CCR section 25137-4.2 [Banks and Financials] and CCR section 25137-12 [Print Media].